SEVEN SUMMITS CAPITAL

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FEBRUARY 2016 INVESTMENT COMMENTARY

DISTRACTIONS, EXPECTATIONS, AND THE SPECULATION GAME

Due to the markets' recent price action, this month's commentary will highlight several of the major distractions that are grabbing the attention of investors, ill-conceived expectations impacting investor psychology, and a frank discussion of why long-term investors often become frustrated with the markets. However, first I am going to provide some insight into the tactics that we engage in within managed portfolios during periods of extreme price volatility.

As I have discussed in previous commentaries, global stock markets have been weak over the last 18 months. Since the beginning of this year, the markets appear to have become entirely disconnected from any relationship to fundamental valuation. During these times, the portfolio management approach that I ascribe to is aptly described by the following quote from A. Alverez, a British poet and author:

"The pleasure of risk is in the control needed to ride with it assurance, so that what appears dangerous to the outsider is, to the participant, simply a matter of intelligence, skill, intuition, coordination... in a word, experience."

At Seven Summits Capital, we are not annoyed by the inconvenience that accompanies market risk. Instead, we acknowledge it, accept it, and manage it. Listed below are several actions that we employ, from a portfolio management perspective, during periods when price volatility over-shadows the fundamental underpinning of security analysis and common sense long-term investing principles:

- When security prices become significantly unhinged from the fundamental characteristics of the underlying source of value creation, we become much more active within portfolios.
- Relative value is a very important concept at Seven Summits Capital. When the market causes security prices to significantly adjust to the downside, the relative valuation between security holdings can and will change in a meaningful manner.
- As we assess the relative valuation of our security holdings versus each other and securities that we have on our "new ideas" list, this assessment dictates adjustments to the holdings within a portfolio. These adjustments can mean that we reduce or eliminate some securities whose relative valuation and risk/return characteristics have become less attractive versus alternatives.
- The process of relative valuation and risk/return assessment is designed to be able to capitalize on price versus value opportunities during periods of significant price dislocation in the markets. Executing this process is intended to increase the potential future total returns of the portfolio by seizing on opportunities that are only present during market conditions such as we have been experiencing since the beginning of 2016.

One of the most significant benefits that Seven Summits Capital provides for clients is the discipline to be able to execute an actively managed, value-seeking, portfolio management process during times of great market stress. Times of great market stress are typically accompanied by any number of factors that can easily distract long-term investors and cause them to take actions that run counter to their long-term strategy.

Some of today's major issues that are distracting many long-term investors from seeing an increasing number of future value opportunities include:

1. China – disorderly markets and economic deceleration.
2. Elevated market price volatility.
3. The near-term direction of U.S interest rates.
4. Perpetual U.S. recession watch re-calibrated on each successive economic data indicator.
5. Political candidate campaign promises/threats that have little chance of being enacted.

For most of January, stock markets around the world sold off. Much of the discussion of what was causing the selling pressure centered around concerns over China's stock market and economy, the prospect of a U.S. recession, political candidate threats of pharmaceutical price controls, and the poorly explained relationship between falling oil prices and falling stock markets.

At Seven Summits Capital, we are always attempting to cut through the constant explanatory chatter that is generated when unusual price action grips our markets. In January, we sent an email to clients providing an explanation of why we believed stock markets were selling off so abruptly and why the direction of stocks seem to be so highly correlated with oil prices. Based upon the research that we conducted on large institutional money outflows, we concluded that, during the second half of 2015, large sovereign wealth funds around the world had been forced to begin liquidating marketable securities in response to falling oil prices. The sovereign wealth funds controlled by countries, such as Saudi Arabia and Norway, have grown exponentially over the last couple decades due to windfall profits from the sale of oil. Now that oil prices have fallen below levels that most of these oil rich nations need to meet their fiscal spending requirements, they are being forced to liquidate investments from their sovereign wealth funds in order to plug the large budgetary deficits that they currently face. These forced liquidations cannot explain all of the selling pressure that our markets are under, however these sovereign wealth funds are large enough to impact market direction when abrupt oil price declines trigger the sale of marketable securities within a short window of time. We surmise that once market direction is turned abruptly negative by these oil price driven liquidations, other "fast money" traders will attempt to play these money flows using short-term strategies. These short-term trading strategies are designed to capitalize on volatility and in doing so, magnify the very price moves that they are attempting to game.

Another market moving storyline that has been getting a lot of attention is the daily handicapping of an impending U.S. recession. Equity markets are hyper-sensitive to changes in perceived recessionary threats and it has always been important to attempt to discern the frequent false alarms from actual recession risks. In terms of economic forecasting, we place significant weight upon the opinion of former Northern Trust Chief Economist, Paul Kasriel. I contacted Dr. Kasriel shortly after the December Federal Reserve meeting and asked him his opinion on whether the U.S. economy could weather another interest rate tightening over the next six months. At that time, Dr. Kasriel stated that one more interest rate tightening between January and June would weaken economic growth further, but the weakness would fall short of a recession. Dr. Kasriel wrote in his January 25th paper titled Recession Imminent? To Quote the Pack's QB, Aaron Rodgers: R-E-L-A-X that "Despite U.S. economic growth slowing to almost stall speed in Q4:2015, the U.S. economy is unlikely to crash anytime soon. Although the Fed is unlikely to reverse its ill-advised December 2015 interest rate increase, it also is unlikely to again raise interest rates and contract reserves until it is sure U.S. real economic growth is back on a sustained 2-1/2%+

trajectory and there are at least some faint signs of inflationary pressures". Looking at how the fixed income and equity markets have been trading since the Federal Reserve increased interest rates last December, one would conclude that the market is foreshadowing an imminent U.S. recession. Manufacturing companies continue to struggle with slack demand and the rising U.S. dollar. Long-term interest rates have fallen, thus flattening the yield curve, and signs of weakness have emerged in the consumer spending and service areas of the economy. A flattening yield curve and weaker than expected cyclical areas of the economy are sending sell signals to short-term traders who attempt to time markets. We are not burying our heads in the sand when it comes to being prepared for the next recession and we acknowledge that the risk of recession in the U.S. has risen of late. However, from our vantage point, the risk of recession is still quite low and the markets are once again over-reacting as they have many times in the past.

It may seem an exaggeration to state that keeping an eye out for a recession is a distraction, but recessions are normal cyclical events and the stock market has not proven to be very good at actually forecasting such economic downturns. Putting distractions aside, many investors unknowingly approach the markets with built-in expectations that they use to inform themselves on the merits of a certain investment or asset allocation. These expectations are formed through past experiences instead of forward-looking analysis and assessments.

Below are some of the most common expectations that I have observed over the last several years, which have been the basis for many poorly conceived investment decisions:

1. The U.S. economy can sustain a 3-4% annual GDP if it were not for certain tax, regulatory and trade policies.
2. The broad U.S. stock market will routinely generate double digit total returns for investors who simply buy the index and hold it going forward.
3. High momentum large and mega-cap growth stocks can defy fundamental valuation metrics indefinitely.
4. The U.S. dollar has been weakened by Federal Reserve monetary policy decisions and a debased currency and uncontrollable inflation will result.

Many of the aforementioned expectations are either rooted in over-simplified macro-economic theories that are commonly discussed in the context of the markets or they are simply common behavioral finance tendencies. We do not subscribe to the idea that it is wise to base investment strategy decisions upon publicized macro events or historical market behavior. The only exception to avoiding speculating on macro events would be factoring in durable macro trends such as demographics and innovation.

The last part of this commentary will examine the market that most observers see every day, which is the speculative game. In terms of equities, this game begins with the well-ingrained practice of focusing on short-term indicators, such as quarterly corporate earnings. This game is dominated by traders who speculate every three months as to what companies will end up reporting better than expected or worse than expected earnings. This quarterly game is a distraction and it fosters significant speculation around well-publicized data points. These quarterly events are what appeal to the traders who "plays" a certain stock or segment based upon the attempt to game market expectations. Investors are bombarded everyday by the play-by-play coverage of the speculation games that have come to define modern "investing". This play-by-play coverage of "the game" has significantly changed the narrative around investing, as evidenced by the commonly uttered questions asked of "stock market pros" in the financial media. Below I paraphrase commonly asked questions that I hear when listening to financial media:

- If X, how are you going to play "fill in the blank" data point?
- If the market does X are you "selling the rip or buying the dip"?
- If the market goes through X resistance level, are you going long or short?

- If the VIX exceeds X, are you taking risk off the table?
- If XYZ stock cannot hold its 50 day moving average are you a seller?

The above questions reveal how pervasive the speculation game has become within the capital markets. The gaming of the markets applies to corporate earnings, economic report data, commodity price direction, and the inferences from each and every word uttered by Federal Reserve officials. The sad truth is that this game only serves the interests of the intermediaries who profit from transactions and financial product sales. The young person accumulating wealth in their early years or the pre-retirement and retirement investors are not served by these games. The typical individual investor does not benefit from playing short-term trading games.

Due to the fact that the speculative game dominates financial media discussion, many investors believe that the success of a given stock investment is driven by incremental short-term metrics, such as quarterly earnings per share. As a long-term investor, one must ask whether beating quarterly estimates by X cents per share or the announcement of a stock buyback or stock split will serve to make a company more valuable over a multi-year period. There is no question that all of these aforementioned factors will move a company's stock price in the short-term, but intuitively how does generating easily manipulated accounting earnings in a given quarter above consensus expectations make the underlying company more valuable? How does taking accumulated corporate cash, or borrowing capital to purchase company stock, increase the value of the underlying company? The answer to these questions is that they do not directly increase the future value of the company. What drives the future value of a company are the investments that the company makes in itself to grow more quickly and to be more competitive and efficient.

For many people who are invested in stocks, the concept of long-term value creation is a mystery, not because it is an obscure concept, but because the game of playing the market is sensationalized by those who report on the market minute by minute. There are many fantastic examples of long-term value creation throughout the history of the U.S. stock market, however Amazon.com is a modern example of a management team that has famously ignored those who have consistently criticized this company for its unorthodox disdain for short-termism. Amazon's founder and CEO Jeff Bezos writes a letter to shareholders each year and in his 2013 letter he stated, "I frequently quote famed investor Benjamin Graham in our employee all-hands meetings – 'In the short run, the market is a voting machine but in the long run, it is a weighing machine.' We don't celebrate a 10% increase in the stock price like we celebrate excellent customer experience. We aren't 10% smarter when that happens and conversely aren't 10% dumber when the stock goes the other way. We want to be weighed, and we're always working to build a heavier company." Bezos is a CEO who refuses to get sucked into the short-term speculative game that traders play. Bezos and Amazon shareholders have benefited over the last ten years from the company's focus on increasing long-term value. Using Ben Graham's famous quote, Amazon's "weight" has increased over 1,400% compared to the S&P 500's cumulative total return of 49% over the last 10 years. Amazon's amazing value creation over the last ten years did not occur without periods when its public stock experienced 30% to 40% corrections along the way. There have been four separate occasions since the beginning of 2006 when the "voting machine" game knocked down Amazon's stock price by over one third, however, just as Ben Graham famously said, 'in the long run, it (the market) is a weighing machine," today Amazon's "weight" is 1,400% greater than it was 10 years ago.

The only way for an investor to most fully benefit from long-term value creation is to see the stock market for what it is…a capitalistic wonder that unfortunately, over time, has become a haven for speculators who participate not as investors, but as gamblers. Saying that the market is a haven for gamblers is not meant to dissuade people from investing in stocks. Instead it is meant to properly align expectations so that true investors can distinguish the difference between the noise, that has become the focus of many market participants, from the opportunity to acquire shares in great businesses at attractive values when those opportunities become available.

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